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C O N F I D E N T I A L SECTION 01 OF 03 KIEV 003129

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TAGS: [PREL](#) [PHUM](#) [ECON](#) [EFIN](#) [MCC](#) [UP](#)  
SUBJECT: UKRAINE: FIRST DEPUTY PM AZAROV COMMITTED TO WTO  
ACCESSION BY YEAR'S END

Classified By: A/DCM Michelle Logsdon for reasons 1.4(a,b,d).

11. (C) Summary: First Deputy PM and Finance Minister Azarov told the Ambassador that by the end of 2006, Ukraine would join the WTO. He pledged that the government would have a careful and well-balanced policy in place to deal with Ukraine's large negative trade balance. On the energy situation, Azarov said that Ukraine would invite investors, including Russia, to help manage the natural gas pipeline transit system, but only in return for substantial new investment in the system and on the condition that Ukraine always maintain a minimum 51 percent share. Ukraine's challenge would be to develop energy-efficient industries over the next 5-7 years. Azarov was interested in the Ambassador's presentation of how Ukraine might qualify for a full Millennium Challenge Account program and gratefully accepted the USG offer of a macroeconomic expert to be attached to the Prime Minister's office. On politics, Azarov said that negotiations on "Our Ukraine" joining the coalition would continue in September when the Rada resumed work. End Summary.

12. (C) Comment. Azarov, who was First Deputy PM and Minister of Finance from 2002-2005, looked relaxed and happy to be back in his old office in the Cabinet of Ministers, and the audible buzz of visitors in his outer office testified to his key role in the new Yanukovych government. Speaking in Russian, Azarov made a definite impression as a man focused on the future and finding practical solutions to current problems, only criticizing his predecessors for leaving him a difficult situation with regard to gas ("when I handed over the office to then-PM Tymoshenko NaftoHaz had no debts and 21 million cubic meters of gas in our storage facilities") and questioning several last-day decisions made by the Yekhanurov government just before Regions took office ("they took ten decisions on the last day that involved more than 1 billion USD and I put a hold on these decisions until we could evaluate them"). Azarov was particularly attentive to the discussion of MCC and promised to appoint someone in his office to work with the USG on the program. End Comment.

WTO - In By the End of 2006

13. (SBU) In response to the Ambassador's question about different comments coming from the Government about when Ukraine might join WTO, Azarov stated plainly that Ukraine wanted to be in the WTO by the end of 2006. Azarov thanked the Ambassador for past USG support on this issue and expressed hope that the USG would also provide the same kind of support to this government. Azarov said that Ukraine still needed to adopt several laws and then reach agreement with Kyrgyzstan on a bilateral agreement, but both of these problems could be resolved. In fact, in Azarov's view, the problem with the Kyrgyz wasn't WTO-related at all. The Ambassador noted that the USG would be happy to help, we had already made efforts with the Kyrgyz, and that Washington

would be pleased with Azarov's commitment to wrap up WTO accession by year's end.

14. (SBU) Regarding possible increases in import tariffs, Azarov noted that Ukraine had a big problem with a negative trade balance. In the first six months of 2006, the trade deficit stood at USD 3 million; by year's end it could easily be USD 6 billion. In addition, Ukraine's currency reserves stood at just USD 18 billion. It was critical for the Government to find a way to reestablish a balance in trade. Azarov noted that a strategy was needed -- it would clearly involve increasing exports and thinking about the exchange rate, and while utilizing the opportunities allowed within the WTO, to limit imports, especially non-critical and non-energy products. There were six countries with which Ukraine had a negative trade balance of nearly USD 7 billion -- more than USD 1.6 billion with China (all non-energy), USD 3 billion with Russia and USD 1 billion with Germany. Azarov stressed that he was not talking about increasing customs duties - this had been a media distortion - but instead was committed to finding a careful and well-balanced policy. "Business should not be afraid." He acknowledged the WTO's "standstill principle" (that while applying for membership, a country should take no steps to restrict trade) and said that Ukraine was aware of what it could do while it was in this "transition period."

15. (U) Azarov was enthusiastic about the Ambassador's offer of help from a full-time USG macroeconomic expert who had worked with previous Prime Ministers and was ready to be of service to Azarov and PM Yanukovich. Noting that he had "always had help from the U.S." in this position, Azarov said that Ukraine was facing a number of challenges, especially in the steel sector, from the expected increases in energy

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prices. He was "ready to sign an official letter" to ask the USG for his help and suggested that he meet with our USG expert on August 15.

#### Energy Sector - Ukraine to Hold 51 Percent

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16. (SBU) Referring to his August 10 meeting with Deputy PM Kluyev and discussion of energy security issues, the Ambassador asked Azarov how he planned to manage NaftoHaz Ukraine's huge debt and the terms of its repayment to RosUkrenergo and Gazprom. Azarov said that when he left office in January 2005 (he was acting PM at that time) and he turned over NaftoHaz's USD 3.5 billion balance sheet to then-PM Tymoshenko, the company had no debts and 21 million cubic meters of natural gas in its storage facilities. Plus Ukraine had contracts for the supply of natural gas with both Turkmenistan and Russia, valid until 2011. Today, NaftoHaz's debt stood at USD 2.5 billion and was a large burden for the budget. He bemoaned the fact that all of this had happened in just 18 months, and stressed the need for an international audit and the use of international accounting standards in order to make NaftoHaz more transparent.

17. (C) Noting that he had raised our concern about control of pipelines with DPM Kluyev, the Ambassador asked how Ukraine would deal with Russian interest in gaining control over the pipeline system in exchange for lower prices for natural gas or debt forgiveness. Azarov said that Ukraine had a different formula in mind. Ukraine would allow Russian investors (and others) to get involved in the management of the pipeline system in exchange for substantial investment. However, Azarov stressed, Ukraine would always control at least 51 percent of the operation. Otherwise Ukraine would lose control of the system and soon be paying USD 230 to 250 per cubic meter for gas. "We understand this very well."

18. (C) Azarov said that Ukraine's long-term dilemma was the need to restructure its industries to be prepared to pay world prices for natural gas. However, a 5-7 year transition period was critical for the Government to institute a serious

energy-savings program and prepare the economy to deal with international prices. The Ambassador noted that the U.S. was ready to help in this area - we had a USD one million pilot energy savings program and advice from experts that would be offered to a large industrial firm through a competitive selection process. Azarov bemoaned the fact that Ukraine was not seizing these opportunities, noting that the World Bank had long tried to implement more than USD one billion dollars in energy savings projects. There were also opportunities to raise money for these projects from the international financial markets - USD 2.5 billion could be attracted annually. If Ukraine used these opportunities, the Government would be able to restructure much of its industrial base within the next five years.

#### VAT Refunds - Critical for U.S. Business

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¶9. (SBU) The Ambassador asked Azarov about an August 9 statement that the Government planned to freeze the payment of all VAT refunds, arguing that this was an important issue for U.S. investors. Azarov acknowledged the concern and pledged that within a week this problem would be resolved. According to Azarov, on August 2, the last day of its existence, the Yekhanurov Government had taken nine decisions that involved more than USD one billion. The Yanukovych Government was concerned about the possibility of corruption, given the large sums of money involved, and had frozen all nine decisions until they could be studied. Azarov told the Ambassador that he could reassure the U.S. investors involved that the VAT refund system would be reinstituted within a week.

#### Interest in MCC

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¶10. (SBU) In response to the Ambassador's short description of the MCC program, Azarov expressed great interest in the program and listened attentively to the details about the MCC Threshold Program and the importance of progress on anti-corruption. Azarov told the Ambassador that he would appoint someone from his office to be involved with the USG on the MCC program.

#### Coalition Politics - Still Talking to Our Ukraine

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¶11. (SBU) Azarov confirmed that negotiations with Our Ukraine about forming a new coalition would continue in September when the Rada reconvened. At this point, the Anti-Crisis Coalition, that had brought Yanukovych to power, consisted of 244 deputies from the Party of Regions, Socialists, Communists and a number of MP's from Our Ukraine

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and BYuT. Regions had worked hard on a coalition agreement with Our Ukraine, but it was "a different kind of organization." Even though most "Our Ukraine" deputies were in favor of establishing a coalition, others did not think it was a good idea. Azarov said that Regions welcomed an expansion of the coalition because it would strengthen the government's foundation. However, if it didn't happen, "we will simply continue to cooperate with Our Ukraine." As Azarov noted, in spite of the lack of a formal coalition agreement, Our Ukraine was well-represented in the Cabinet. He also mentioned that during the period of negotiations, Regions had stayed in close touch with President Yushchenko to ensure that he wanted to cooperate -- "we are interested in the support of the President (Yushchenko), and we are ready for compromise."

¶12. (SBU) In Azarov's view, the recently-signed "Universal" would not be the basis for a new coalition agreement. The Universal was a declaration of the vision for the country. Regions and Our Ukraine had agreed on a good coalition agreement back in the May/June time frame. The Socialists had signed on, but the Communists had disagreed with a number of points. According to Azarov, there had been no time to finalize negotiations in August and the negotiating process

would continue again in September.

¶13. (U) Visit Embassy Kiev's classified website:  
[www.state.sgov.gov/p/eur/kiev](http://www.state.sgov.gov/p/eur/kiev).  
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